



TESTIMONY OF

GRACE L. HINCHMAN

SENIOR VICE PRESIDENT

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

GOVERNMENT REFORM SUBCOMMITTEE on REGULATORY AFFAIRS of THE
COMMITTEE ON GOVERNMENT REFORM

AT A HEARING ON

THE SECURITIES AND EXCHANGE COMMISSION'S
IMPLEMENTATION OF THE SARBANES-OXLEY ACT, WITH PARTICULAR
ATTENTION ON THE REQUIREMENTS OF SECTION 404

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Thank you Chairman Miller, Ranking Member Lynch and Members of the Subcommittee for this opportunity to appear before you today. I have prepared remarks, I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

My name is Grace Hinchman and I am the Senior Vice President of Financial Executives International (FEI). FEI is the leading organization of 15,000 members including CFOs, Treasurers, Controllers, and other senior financial executives. I am pleased to have the opportunity to share the views of our members with you today on the important issue of the SEC's implementation of the Sarbanes-Oxley Act and in particular Section 404 of the Act, which addresses internal control over financial reporting.

STRENGTHENING CORPORATE GOVERNANCE, INTERNAL CONTROLS

First, FEI strongly supports the goals of the Sarbanes-Oxley Act, as it has enhanced the role of corporate financial executives and created a greater appreciation for their role within the corporate environment and among the public generally. Specifically, Section 404 of the Act has also strengthened the ability of financial executives to institute continuous improvements in internal controls and financial reporting and to gain enhanced “buy-in” by all employees of the need for strong internal controls. The Act has resulted in the following positive developments:

- Strengthening the tone at the top by requiring certifications of financial statements by CEOs and CFOs, and by requiring management and auditors' reports on internal controls over financial reporting;
- Strengthening the incentives for high quality financial reporting that can be relied upon by the public, by increasing penalties for doing otherwise, including, importantly, the

federal sentencing guidelines for criminal conduct in connection with fraudulent financial reporting;

- Strengthening the requirements for audit committees, which play such a critical role in corporate governance on behalf of the investing public;
- Making the internal control process more rigorous, and heightening accountability; and
- Limiting transactions such as loans to officers, which is part and parcel of good corporate governance.

Even before Sarbanes – Oxley, internal controls were a long established management tool used to detect and correct deficiencies. Companies have long had what are referred to as “management letters” from their auditors in which certain internal control weaknesses are noted in addition to reports of their own internal audit staff. The Sarbanes-Oxley Act has added gravitas to the impact of any reports of substantive internal control weaknesses and the need to correct them by raising the bar of public disclosure of material weaknesses. Today, public companies, both large and small, must show that their system of internal control over financial reporting is effective and without material weaknesses. This focus on strength and effectiveness in a company’s system of internal controls should enhance a shareholders faith in the integrity of a company’s financial reporting data. FEI believes it is critical, that in order for Section 404 of Sarbanes-Oxley to be most effective, requirements of a management assessment and supporting attestation on internal controls must be integrated with management’s and auditor’s efforts surrounding the presentation and audit of a company’s financial reporting.

Overall, FEI believes that the heightened emphasis on internal controls, corporate governance and the enhanced role of financial executives brought about by Sarbanes – Oxley have all been very positive.

IMPLEMENTING THE SARBANES-OXLEY ACT OF 2002

While many of the mandates of the Sarbanes-Oxley Act were effective upon the adoption of the legislation, much of the Act directed the SEC and PCAOB to develop the “rules” of implementation of the Act. Generally, the SEC and the PCAOB have done an impressive job in fulfilling a difficult task by striking a balance in efficiency and cost effectiveness while maintaining the integrity and intent of the statute. However, the rules and standards related to the implementation of Section 404 of the Act still require significant attention.

I would be amiss if I did not acknowledge the SEC’s recognition of the additional “regulatory overload” its proposal to accelerate the 10-K and 10-Q filing deadlines presented to publicly held companies especially in light of the new Sarbanes – Oxley compliance requirements. Moreover, the Commission has remained mindful of this “regulatory overload” by remaining flexible and demonstrating a willingness to postpone the final implementation of the accelerated filing deadlines and allow companies to devote resources to Section 404 implementation.

FOCUS ON INTERNAL CONTROLS

Over the past few years, FEI has been especially active in working with its members to provide assistance for effective and efficient implementation of the Act generally and Section 404 specifically including the PCAOB’s Auditing Standard No. 2, (AS2) *Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

FEI's Committee on Corporate Reporting (CCR) has held two sessions with Section 404 project leaders from many of the Fortune 100 companies to share practices for implementation, and to identify efficiencies as well as areas for improvement. These sessions and their outcomes were documented in two reports by FEI's Research Foundation (FERF) in May and November 2005, which I have included in my written testimony.

FEI's President and CEO, Colleen Cunningham, as well as members of CCR, participated on the SEC's and the PCAOB's Roundtable on Internal Control Reporting in April 2005. We look forward to participating again at the next Roundtable scheduled for May 10, 2006. We believe that these Roundtables are critical to successfully implementing and sustaining the process surrounding Section 404 for preparers and auditors alike. We applaud the SEC and the PCAOB for organizing these sessions.

Additionally, several of FEI's technical and policy committees have filed numerous comment letters on Section 404 implementation issues but we consistently acknowledge that the SEC and the PCAOB are working diligently to achieve an effective and efficient process for Section 404. There are continuing concerns by many FEI members about particular issues that are becoming increasingly evident especially regarding the overall cost of compliance and the ability for many companies to sustain their ability to meet these regulatory requirements.

Although, the SEC maintains final authority over the rules and standards to implement the requirements of Section 404, much of the rule-making and standards setting has come from the PCAOB's AS2. Since the SEC's approval of AS2 on June 17, 2004, the PCAOB and the SEC have continued to release additional guidance to supplement AS2 through policy statements and detailed Staff Q&As. While we believe this additional guidance has been helpful to both

preparers and auditors alike, they have fallen short of providing a completely effective and efficient implementation process.

In May 2005, as a result of the feedback received at their April 2005 Roundtable, the SEC and the PCAOB issued additional guidance intended to create greater efficiencies in implementing Year Two of Section 404. FEI continues to support the key tenets of the May 2005 SEC and PCAOB guidance but we believe that additional focus and attention is needed on some of the most critically important tenets:

- The need for integration of the audit of internal controls with the audit of a company's financial statements;
- The need to use a top-down, risk based approach to implementation;
- The need to exercise flexibility and use of judgment in using the work of others.

FEI firmly believes that Section 404 of Sarbanes-Oxley is workable and does not require Congressional action. Instead, the SEC and the PCAOB need to take a reasoned approach to sustaining implementation and to focus auditors and companies more on embracing the key tenets of the SEC and PCAOB guidance versus drowning in the minutia of detailed documentation.

SMALLER COMPANY CONCERNS

The SEC should be commended for its work in establishing the Advisory Committee on Smaller Public Companies (ACSPC) to review and consider the regulatory issues affecting smaller public companies especially the impact of Sarbanes-Oxley compliance. FEI recognizes the concerns with the significant and even disproportionate economic impact the Sarbanes-Oxley Act continues to have on smaller companies.

Smaller companies simply do not have the resources found in the larger companies to sustain the financial and personnel requirements of Sarbanes-Oxley. Smaller public companies are anxious about the high cost of implementing the Sarbanes-Oxley provisions, especially the 404 provisions. FEI believes that some relief is warranted, especially to the micro cap companies. If something does not change, FEI is concerned that many micro cap companies may be driven into extinction in their efforts to comply with the Sarbanes-Oxley requirements. FEI's Small Public Company Task Force (SPCTF), recently filed comments regarding the SEC's ACSPC's recommendations. A copy of FEI's SPCTF comment letter is attached. The SPCTF recommends that further study and guidance is needed to address the core issue of improving the cost-benefit equation of complying with Section 404.

Both the SEC and the PCAOB have the authority today to tailor compliance of Section 404 so it meets the capabilities of all public companies large and small. Such guidance should come in the form of "right-sizing" AS2 in a separate standard directed at smaller public companies in particular, or through "right-sizing" AS2 to address the needs of small and large companies alike. The "right-sized" standard can reflect learnings of the SEC ACSPC as well as information provided at the upcoming May SEC-PCAOB roundtable. FEI remains convinced that the regulatory and standards setting processes possess adequate authority and flexibility to address the Section 404 implementation challenges.

In addition, consideration should be given as to whether the SEC needs to issue further guidance for management, and smaller public company management in particular. As has been widely noted, the SEC's management reporting rule under Section 404 provided sparse guidance for management, and AS2 became the de facto guidance. Although the Committee Of Sponsoring Organizations (COSO) is developing guidance for smaller public companies, it is

not yet final and it is unclear whether such guidance will be helpful to smaller public companies in its final form. As one of the sponsoring organizations for COSO, FEI does not support elevating COSO to a standard-setting role.

COST- BENEFIT OF IMPLEMENTATION

I would be remiss if I do not focus a portion of my remarks on the overall cost-benefit of the Sarbanes-Oxley Act. We appreciate the SEC's and PCAOB's acknowledgment that cost of implementation is high. The degree of testing and documentation of internal controls forms the largest part of the cost, and incorporates the need to pay internal staff, both finance and internal audit, as well as the external auditor, and other external experts such as software consultants, to enhance systems related to testing, documenting, and reporting on internal controls. We especially note the significant cost impact on smaller public companies, as they simply do not have the resources to carry out the reporting requirements. The benefit side of the equation, while it includes the strengthening of the role of the financial reporting and internal control process, increased shareholder confidence is still much more difficult to measure and quantify. While FEI certainly supports such intangible benefits, we believe that good corporate governance encompasses not only strong internal controls, but also an eye toward budget, profitability, and as such, cost-benefit issues.

FEI continues to urge regulators to maintain flexibility and judgment that would promote efficiencies rather than redundancies, and minimize extraneous, labor-intensive procedures that are time consuming and expensive. While we do believe that greater efficiencies have been witnessed in year two of implementing Section 404, FEI remains hopeful that more reasonable approaches will continue to be developed that will further reduce the cost of compliance as regulators, preparers, and auditors work together to implement the spirit of the SEC rules and

PCAOB standards. It is our hope that reasonableness will prevail, particularly in the roll forward of continuous testing and documentation in future years.

FEI's COST SURVEY on IMPLEMENTING SECTION 404

FEI has been surveying its membership on Section 404 Implementation costs since May 2003. In March 2006, FEI surveyed 274 public companies, with average revenues of \$5.7 billion, (the range being under \$25 million to over \$25 billion in revenues) to gauge Section 404 compliance cost estimates. Of the 274 respondents, 193 were second year filers, 56 were first year filers, and 25 had not yet filed their results. The survey results showed:

- The total cost of compliance with Sarbanes-Oxley Section 404 is now estimated at \$3.70 million for the average company.
- Total cost is a function of internal costs such as internal audit, external costs other than the auditor (such as external consultants and software packages) and audit fees attributable specifically to the Section 404 internal control attestation.
- According to the survey, the average company expended \$1.06 million in internal costs (a decrease of 12.2% for second year filers from their first year of implementation), \$1.26 million in external costs (a decrease of 21.7%) and \$1.38 million in auditor fees (a decrease of 12.7%).
- In total, companies indicated that audit attestation fees represent 44.2% of their total annual audit fees.
- In looking at the implementation cost based on a company's market capitalization, on average, a microcap company with market capitalization less than \$128.2 million had total costs of \$1.19 million, a small cap company with market capitalization between

\$128.2 and \$787.1 million had total costs of \$1.29 million and a large public company with a market capitalization greater than \$787.1 million had \$5.33 million in total costs.

Based on the data obtained, it appears that even in its second year of implementation, while companies have experienced some reduction in costs, most significantly in the area of external costs other than the auditor, the cost of Sarbanes-Oxley Section 404 compliance remains high, and continues to be disproportionate to the burdens associated with annual compliance.

WORKING TOWARDS A SOLUTION

In conclusion, FEI supports the efforts of the SEC and the PCAOB in implementing the requirements of the Sarbanes-Oxley Act of 2002. However, it is evident that more work needs to be done in implementing Section 404 of the Act. We are confident that the SEC and PCAOB are up to the task and they possess the authority to do so. Through continuous study, review and feedback from large company and small company preparers, auditors, regulators and investors by the SEC and the PCAOB, FEI is confident that a reasoned approach to Section 404 implementation that is “right-sized” for all public companies will be achieved.

That concludes my remarks. I want to thank the Chairman and members of the Subcommittee for inviting me to participate in today’s hearing.